Global Foreign Exchange Division
St Michael's House
1 George Yard
London
EC3V 9DH

<u>TO:</u>
Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Ontario Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Office of the Superintendent of Securities, Prince Edward Island

Josée Turcotte, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8
E-mail: comments@osc.gov.on.ca

Me Anne-Marie Beaudoin, Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3
E-mail: consultation-en-cours@lautorite.qc.ca

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Re: Canadian Securities Administrators (CSA)
CSA Proposed National Instrument 94-101 and Companion Policy – Mandatory Central Counterparty Clearing of Derivatives

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) welcomes the opportunity to comment on behalf of its members on the proposed National Instrument and Companion Policy issued by the Canadian Securities Administrators on 12 February 2015.

The GFXD was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 24 global FX market participants,[1] collectively representing more than 90% of the FX inter-dealer market.[2] Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

Introduction

The FX market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. Many of the current legislative and regulatory reforms have had, and will continue to have, a significant impact upon the operation of the global FX market, and the GFXD wishes to emphasise the desire of our members for globally co-ordinated regulation which we believe will be of benefit to both regulators and market participants alike.

The FX market is the basis of the global payments system. The volume of transactions is therefore very high and these transactions are often executed by market participants across geographical borders. As reported by the Bank of International Settlements in their 'Triennial Central Bank Survey: Foreign Exchange Turnover in April 2013'[3] over 75% of the FX activity was executed by market participants across 5 global jurisdictions, hence the continued view from the GFXD that regulations should be harmonised at the global level. Cross border markets cannot operate in conflicting regulatory landscapes and the natural outcome, should this be the case, is unwanted fragmentation of what is an already highly automated and transparent FX market. Canada presents a more granular harmonisation challenge and we recommend that the CSA prioritises the harmonisation of legislation, both across provinces and at the international level. On this note, the GFXD welcomes the CSA's decision to make the conversion to National Instrument from Model Provincial Rule for the purposes of harmonisation.

Achieving a globally harmonised mandatory clearing regime is of particular importance. Where there are jurisdictional differences in the clearing regimes, a party conducting a cross-border trade may be required to centrally clear that trade, when in their home jurisdiction they would not necessarily be mandated to do so. This lack of consistency not only results in increased complexity of trade flows and execution decisions for market participants (with associated increased transaction costs) but also does nothing to mitigate the greatest risk involved in FX trading, which as discussed below is settlement risk, not mark-to-market risk as seen with other products.

Many of the current legislative and regulatory reforms will have a significant impact upon the operation of the global FX market. The GFXD feels it is vital that the potential consequences are fully understood and that new regulation improves efficiency and reduces risk. The GFXD welcomes the opportunity to set out its views in response to the proposed National Instrument and Companion Policy.

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[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi, Barclays Capital, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Mizuho, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.
[2] According to Euromoney league tables
[3] http://www.bis.org/publ/rpfx13fx.pdf

Proposed National Instrument 94-101: GFXD Comments

We have no additional comments on the text of parts 1-3. In parts 4-6 we would like to bring to the CSA's attention the following concerns:

1. <u>Clearing obligation determination</u>

The GFXD is concerned by the removal of text relating to the clearing obligation determination from the text of this proposed National Instrument.

In the previous draft text (Proposed Model Provincial Rule 91-303) of this proposed National Instrument, it was understood that both a 'top down' and a 'bottom up' approach to the determination of the clearing obligation could be used. This was apparent from the Model Provincial Rule Part 4 (13) and the Companion Policy Parts 4&6 (12&14). However, these sections of 91-303 do not appear in the draft text of 94-101 Annex B, or in Annex A, which outlines the textual changes that have been made following comments received on 91-303.

Whilst we understand that the process for determining the clearing obligation may be implicit in the proposed National Instrument, and that the CSA reserves the right to use a 'top down' approach even where one is not specified, we respectfully suggest that, to provide certainty and to promote harmonisation with other jurisdictions, the procedures for determining a clearing obligation are clearly drafted and aligned as closely as possible with the existing approaches of Dodd Frank in the US[4] and European Markets Infrastructure Regulation (EMIR) in Europe[5]. Specifically these two jurisdictions have similar processes for determination of the clearing obligation, utilising the 'top down' and 'bottom up' approaches as briefly outlined in Figure 1

Figure 1: Comparison of US and European clearing determination procedures

Europe		US	
'Bottom Up' ***EMIR 5 (1-2)***	**'Top Down'** ***EMIR 5 (3)***	**'Bottom Up'** ***17 CFR part 39.5 (b)***	**'Top Down'** ***17 CFR part 39.5 (c)***
CCP applies to NCA to clear a class of OTC derivatives	ESMA proposes that a class of derivatives should be subject to the clearing obligation	CCP applies to CFTC to clear a class of OTC derivatives by at least the start of the preceding business day from intended start date	CFTC regularly reviews all derivatives not subject to clearing obligation and decides to propose a class
kNCA grants authorisation	↓	CFTC grants determination	↓
NCA immediately notifies ESMA	↓	↓	↓
Within 6 months, ESMA conducts public consultation, and consults ESRB and relevant 3rd country NCAs	ESMA conducts public consultation, and consults ESRB and relevant 3rd country NCAs	CFTC conducts 30 day public consultation	CFTC conducts 30 day public consultation
ESMA publishes determination	ESMA publishes determination	No more than 90 days after submission, CFTC makes determination	CFTC makes determination
	If no CCP clears that class of derivative, ESMA publishes call for development of clearing proposals. [For exchange of collateral on OTC derivatives see EMIR 11 (14)]		If no CCP clears that derivative, CFTC will investigate and take necessary action e.g. imposing margin requirements

[4] 17 CFR part 39.5 (b-c)
[5] EU Regulation 648/2012 (EMIR) 5 (1-3)

GFXD also notes that in the original text of 91-303, the consultation/comment period was set to 60 days. GFXD agreed with this proposal, and further agrees with the clarification requested by the International Swaps and Derivatives Association (ISDA) in their response to 91-303[6]: that even in cases where no public consultation is to be held, there should still be a minimum 60 day notice/comment period of intention to make that class of derivatives subject to mandatory clearing.

2. Public register

The GFXD notes that the text relating to the public register has been removed from the proposed National Instrument itself, and is now mentioned in the introductory text as follows: *"the list of mandatory clearable derivatives will be included in the Clearing Rule as Appendix A, amended from time to time. In Québec the determination process will be made by decision and the list of mandatory clearable derivatives will appear on a public register kept by the Autorité des marchés financiers"*. In the interests of transparency and clarity, and to allow for ease of comparison between jurisdictions, we recommend that the list of mandatory clearable derivatives is kept in one place on behalf of all the Canadian securities regulators, including Québec.

The GFXD also seeks additional clarity on the determination process 'by decision' which is mentioned in relation to Québec. Specifically, that it includes the minimum 60 day comment period as described in ISDA's response (see footnote 6), to ensure consistency across provinces.

Implementation

The GFXD suggests that the CSA leverages the approaches used within Europe and the US when considering the thresholds for the phased implementation of mandatory clearing.

A gradual approach to the introduction of clearing to the Canadian market would allow the CSA to fully assess the impact of mandatory clearing rules in the US and Europe, as these rules are not yet in action. In the interests of global harmonisation and to prevent market fragmentation, we suggest that the CSA looks to the clearing regimes of these major jurisdictions first and draws upon them in creating a Canadian clearing regime. This extends, for example, to excluding from the clearing regime products that are not clearable in the US or Europe.

FX OTC Clearing – Market Characteristics

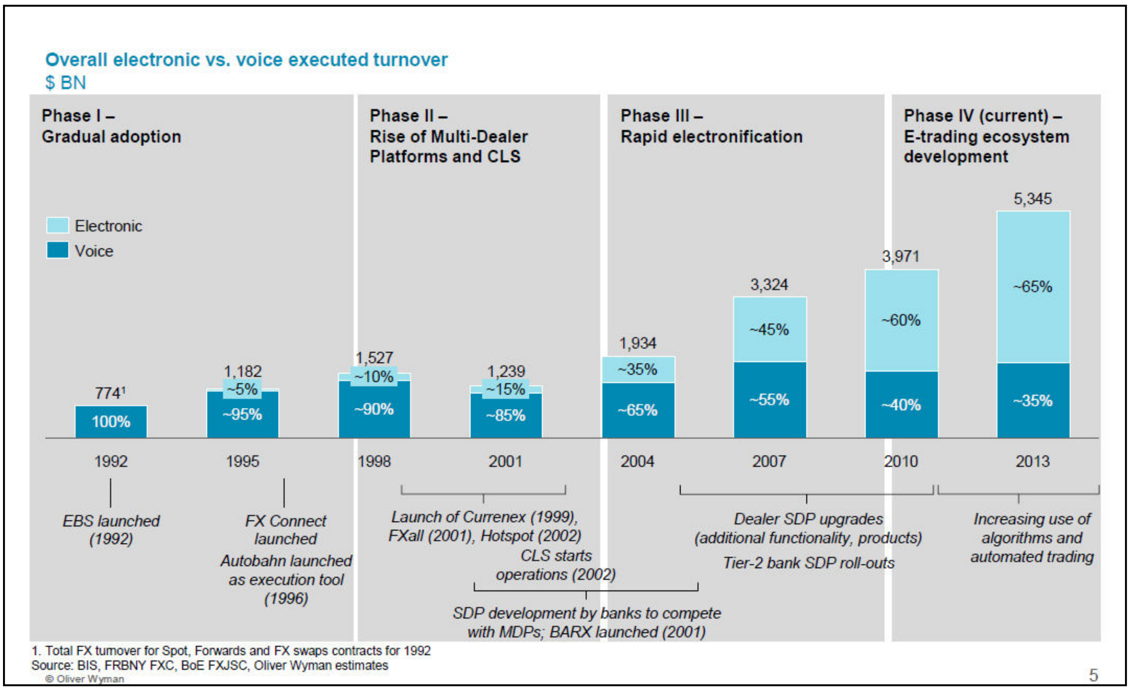
In addition to our comments on the text of the proposed National Instrument, we would like to bring to the CSA's attention a number of characteristics of the FX market, which are relevant to the discussions on mandatory clearing. For more information, we refer the CSA to our responses to 91-303 (Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives[7]) and 91-406 (Derivatives: OTC Central Counterparty Clearing[8]).

In its introduction to the proposed National Instrument, the CSA says that the purpose of mandatory clearing is *"to improve transparency in the derivatives market and enhance the overall mitigation of systemic risk"*[9]. To the first point, the FX market already has a **high degree of transparency**. Transparency for regulators comes in the form of trade reporting to a trade repository, which in Canada is required for FX forwards, swaps, NDFs and options. For market participants, transparency is in the form of public reporting of price and volume, which is already in force for bilateral transactions reported to

[6] http://www2.isda.org/regions/canada/page/2 or http://www.osc.gov.on.ca/en/SecuritiesLaw_com_91-303_index.htm
[7] http://gfma.org/correspondence/item.aspx?id=582
[8] http://gfma.org/correspondence/item.aspx?id=364
[9] Substance and Purpose of the Proposed National Instrument, page 2

trade repositories[10], and which the CSA has proposed for venue trades in its consultation paper 92-401 on derivatives trading facilities. Additionally, a recent study by the GFXD and Oliver Wyman showed that the FX market is ~65% electronically traded – see Figure 2 – which results in diverse availability of pricing information. Given the above, it is therefore not apparent how mandatory clearing will increase the already high level of FX market transparency for either regulators or market participants.

Figure 2: Overall electronic v voice executed turnover in the Global FX market (GFXD/Oliver Wyman 2015)



With regards to the CSA's second point, mitigation of systemic risk, it should be noted that the **predominant risk in the FX market is settlement risk** (i.e. the risk that one counterparty delivers their side of the currency exchange while the other counterparty does not), and not mark-to-market risk. According to the BIS 1993 Noël Report *"the loss of principal in settling, for instance, a foreign exchange trade would dwarf any gain or loss that might have accrued to the counterparties to the original transaction"* [11]. Clearing agencies, on the other hand, are designed to mitigate the 'mark-to-market' risk, which is managed in the FX markets through Credit Support Annexes between counterparties. Settlement risk has also been virtually eliminated due to the creation of CLS Bank in 2002, an organisation which is subject to a cooperative oversight protocol arrangement between the banks of the 17 currencies that settle through CLS, including the Bank of Canada.

The FX market is mostly physically settled (i.e. trades settle by full exchange of currencies), whereas other derivatives markets settle trades largely financially. In 2013, the FX market was sized at $5.3 trillion per day[12]. When combined with physical settlement of trades, this results in very **large currency and capital needs**, which would have to be met by clearing agencies if physically settled FX products were to be made subject to mandatory clearing. This can be contrasted with most other OTC derivative markets, where trades are settled on the basis of net cash settlement in a single

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[10] 91-507 Trade Repositories and Derivatives Data Reporting, 39 (3)
[11] BIS *Central Bank Payment and Settlement Services with respect to Cross-Border and Multi-Currency Transactions,* 1993 (Noël Report) available at http://www.bis.org/publ/cpss07.pdf. See also See BIS CPSS *Settlement Risk in Foreign Exchange Transactions,* 1996 (Allsopp Report) available at http://www.bis.org/publ/cpss17.pdf.
[12] Bank for International Settlements (BIS) Triennial Survey: http://www.bis.org/publ/rpfx13fx.pdf

currency that only reflects the mark-to-market value of the trade. As noted in the US Treasury's Fact Sheet on its exemption of FX forwards and FX swaps from mandatory clearing in November 2012, *"settlement of the full principal amounts of the contracts would require substantial capital backing in a very large number of currencies, representing a much greater commitment for a potential clearinghouse in the FX swaps and forwards market than for any other type of derivatives market"*[13].

In 2014 the GFXD produced the results of research[14] into the size of the FX options market, which accounts for ~6% of the global FX market, to establish the scale of the liquidity challenge of clearing physically settled FX options. The study, which covered over 90% of OTC FX dealer flow, estimated the size of the same-day liquidity risk (in order to credibly guarantee full and timely settlement of the currencies traded for this product) to be the equivalent of $161 billion for each day, across 17 currencies. At present, the market infrastructure for the clearing of physically settled FX options is not equipped to meet this substantial funding challenge. However the industry is collectively working together to meet this challenge.

It should also be noted that **voluntary clearing for FX products is still in its early stages**. For example, ESMA cited the immaturity of FX non-deliverable forward (NDF) clearing in its February 2015 determination that FX NDFs are not appropriate for mandatory clearing at this time[15]. By way of comparison, while an estimated 0.4%-3.6% FX NDF contracts (which account for ~3% of the overall FX market) are currently being cleared, the introduction of the clearing mandate for IRS and CDS was predicated on far more developed markets, with many start-up issues addressed while clearing of these products was still voluntary. At the time of introduction of clearing mandates for IRS (in 1999) and CDS (in 2009), approximately 60% and 30% respectively of contracts were being voluntarily cleared.

FX clearing services need time to mature, for their practices to be properly bedded down and "battle-tested" and for fundamental unresolved issues to be properly addressed. In Europe, for example, only two clearing agencies are currently authorised for the clearing of NDFs. Additionally, voluntary clearing for FX products as a whole is still limited to the inter-bank market. As a result, premature introduction of mandatory clearing in FX products may unnecessarily introduce additional risk to this global currency market and, as a result, undermine the benefits of central clearing.

Finally, we note that **FX products are not homogenous**, and must therefore be considered separately by product, by tenor and by currency pair. In particular, liquidity by currency pair and tenor varies significantly. If clearing is to be introduced for any products in the FX market, it is crucial that it should be limited to only the most liquid currencies. Furthermore, we recommend that the CSA requires specific information from any clearing agency applying to clear a product, on the end-to-end testing conducted with its clearing members for that market. This information should cover two areas: (1) the scenario analyses / stress testing performed by the clearing agency, the default management processes for the clearing agency and resulting impact on the underlying liquidity in the FX product(s) that the clearing agency clears or plans to clear, and the arrangements in place to address management of sovereign risk events (e.g. suspension of trading, sovereign default, unexpected bank holiday or other significant disruption to valuation, payment or settlement processes); and (2) a description of the manner in which the clearing agency has provided information to the central banks of the relevant currencies on its clearing of FX products, including but not limited to (1) above, and a summary of any views expressed by the central banks to this

[13] US Treasury Press Release 'Fact Sheet: Final Determination on Foreign Exchange Swaps and Forwards' http://www.treasury.gov/press-center/press-releases/Pages/tg1773.aspx
[14] http://gfma.org/Initiatives/Foreign-Exchange-%28FX%29/FX-Options-Clearing/
[15] http://www.esma.europa.eu/system/files/2015-esma-234_-_feedback_statement_on_the_clearing_obligation_of_non_deliverable_forward.pdf

information – especially if the clearing agency's services were extended to deliverable OTC FX contracts, whether forwards, swaps and even options. Because the deliverable FX market is a central component of the global payment system, central banks have expressed a need to understand and evaluate the impact of clearing by clearing agencies, individually and collectively, on the deliverable OTC FX market from a broad policy perspective.

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We appreciate the opportunity to share our views on this consultation paper issued by Canadian Securities Administrators. Please do not hesitate to contact Fiona McKane on +44 207 743 9317, email fmckane@gfma.org or Andrew Harvey on +44 207 743 9312, email aharvey@gfma.org should you wish to discuss any of the above.

Yours sincerely,

James Kemp
Managing Director
Global Foreign Exchange Division, GFMA